THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 326 **July 2000**

There seems to be a widespread perception that the global economy now stands on the brink, but the brink of what remains the question...the beginning of a long boom, driven by technology and deregulation, or whether it is significantly exposed to a downturn through which long-standing macro economic imbalances will eventually be resolved... Looking further ahead, the biggest policy challenge could be coping with a sudden reversal in the fortunes of the dollar.

***The Bank for International Settlements, 70th Annual Report*, June 2000**

ON BORROWED TIME

One overwhelming question presently confronts policymakers, economists and investors: how will the exciting U.S. economic and financial party end? There is a widespread elevated perception that today's U.S. economy is the strongest, the healthiest and the most flexible not only in the world, but in history. Yet the economy is plainly entering the closing stages of its unusually prolonged and strong expansion. It has during the past four years outperformed all other countries in the pace of economic growth and the scale of financial wealth creation. There has been stock market exuberance as never before witnessed—not even in the late 1920s. European policymakers and corporate managers look enviously at the American-style capitalism that has created this apparent economic miracle, while their own model is badly failing.

First, a few signs are signaling a slowdown in the consumer-spending boom. To the stock market, this should primarily warn that profits will at best erode and at worst plummet, inherently implying a dampening effect on stock prices. But yearning for the next market rally, investors have latched, instead, on the hope that the softer-looking data may weaken the Fed's resolve to implement further rate hikes. With bullishness still rampant in the markets, the news of slower economic growth is good news on the assumption that, thanks to the economy's extraordinary health and Mr. Greenspan's extraordinary wisdom, nothing worse than a temporary, limited economic slowdown is possible.

What is really in the making in the United States? Soft or hard landing of the economy? Is this just a correction in the stock market to be followed by the ascent to new highs? Dollar correction or dollar crash? To be sure, these are *the* questions of 2000-01, which we keep exploring. The greatest hazards are, essentially, in the stock market and in the currency market, and there in particular in the dollar-euro exchange rate. Decisive for the final outcome in the two markets is, in the last analysis, the kind of economic landing that Mr. Greenspan will manage.

The markets are clearly betting on a soft landing. Implying a controlled transition from vigorous to moderate economic growth without recession. The hard landing describes a more abrupt transition that culminates in recession, if not depression. It would be bullish for government bonds and very bearish for the stock market, the dollar and lower-grade bonds.

Adhering to the famous postulate of Austrian theory that the length and the severity of recessions or depressions depend critically on the magnitude of the dislocations and imbalances that have accumulated in the economy during the preceding boom, we take it for granted that a hard, even a very hard, landing is absolutely inevitable for the U.S economy. In his book The Great Depression, (1934) Professor Lione Robbins wrote: "The effects of an earthquake are, in part, a function of the strength of the original shocks, in part a function of the strength of the buildings affected." We think the U.S. financial building, built on nothing but leverage, is of

unprecedented vulnerability.

THREE CREDIT OUTLETS

The broadest indicator of economic and financial vulnerability is the pace of credit and debt creation in relation both to current GDP growth and available current savings. By both measures, the U.S. economy of the 1990s easily ranks as the worst bubble economy in history. Last year, nominal GDP growth of $494 billion was associated with total credit growth of $2,200 billion. Precisely one-half of the new borrowing was on behalf of business and consumers and the other half on account of borrowers in the financial sector (particularly government-sponsored enterprises and mortgage and asset-backed pools). The government paid down $71 billion of its debts, while state and local governments added $53 billion to their debts. The net result of this borrowing binge was that for each dollar added to GDP there were $4.45 added to overall debts.

Now, let's have a closer look at how all the borrowed money was actually used. In principal, a credit expansion has three potential kinds of outlet: *first*, purchases of goods and services; *second*, purchases of imported goods; and *third*, employment in the financial circulation. Of last year's U.S. credit expansion, the $494 billion, recorded as GDP growth, essentially reflected a corresponding increase in consumer and business spending on goods and services from current domestic output. Another $105 billion of the credit expansion went into higher net imports. That is, of the overall credit creation of about $2,200 billion only about $600 billion, were spent on consumer and investment goods and services.

NOTHING BUT FINANCIAL LEVERAGE

And what about the remaining $1,600 billion of the total credit creation. Where has all that money gone? Essentially, the largest part of the credit creation was poured into the purchase of existing financial or real assets. In the United States, it went overwhelmingly into financial assets. This category includes the large-scale corporate borrowing for the purpose of acquisitions, mergers and stock buybacks. In the same vein, private households poured vast amounts into the stock market, which they had borrowed through refinancing and increasing the mortgage on their home. Putting it bluntly, consumers and businesses used less than half of their borrowing for the purchase of goods and services. The greater part has been feeding the speculative mania in the financial markets. It keeps amazing us that American economists, including Mr. Greenspan, flatly ignore the zooming credit numbers.

Although the general stampede into debt is a well-known fact, there is little or no attempt to consider inherent ill-effects on the allocation of resources. What's more, one credit category that has catapulted to unprecedented importance in the last few years is treated with complete disregard: the skyrocketing borrowing and lending by the financial sector, so-called *financial credit*. Ending the first quarter of 2000 at almost $7,800 billion, these credits have more than doubled since 1994.

In the view of policymakers and economists, these borrowings don't deserve any attention because they occur entirely outside of the GDP in the financial sphere. Neither the goods markets nor GDP growth is affected. To asses the role and the effects of these credit flows, first let's take a look at the numbers. During the three years, 1997-99, the amount of outstanding "financial credit" ballooned by almost $2,800 billion, or an amazing 58%. In detail, the various groups of financial institutions registered jumps in their asset holdings as follows: GSEs $765 billion, or 77%; Federally-related mortgage pools $610 billion, or 36%; Issuers of Asset-backed securities $802 billion, or 94%; and Security Brokers/Dealers $503 billion, or 79%.

These are credit flows of stunning scale. Yet, for the reasons mentioned, they are dismissed from any consideration as completely irrelevant for the economy and the financial system. We wonder why they exist at all, being irrelevant. The ugly truth is that the explosion of this credit category has in reality been a key element in fueling and sustaining the U.S. economic and financial bubble. Considering the near-zero supply of savings

in the United States, it is a safe bet that the exponential rise in the asset holdings of these institutions essentially has one single source of financing: leverage. In short, these flows represent a most important, if not the decisive, source of the great American bubble.

Or putting it differently, America's financial boom of the last few years has been built on nothing but leverage upon leverage. In the last analysis, the vanished supply of domestic savings has been substituted, actually vastly more than substituted, by literally boundless credit creation for the purpose of leveraging asset holdings. Is that relevant for the economy and the financial markets? Actually, it is of utmost relevance because it is bound to generate artificially low interest rates, which have been crucial in fueling the bubble. Judging by the preposterous scale of financial leveraging that has over time been built into the system, this interest effect must have been substantial. The all-important thing to see is that the Federal Reserve has readily abandoned any control of money and credit creation. The power of the American credit machine to create credit out of the blue is unique and unprecedented in the world.

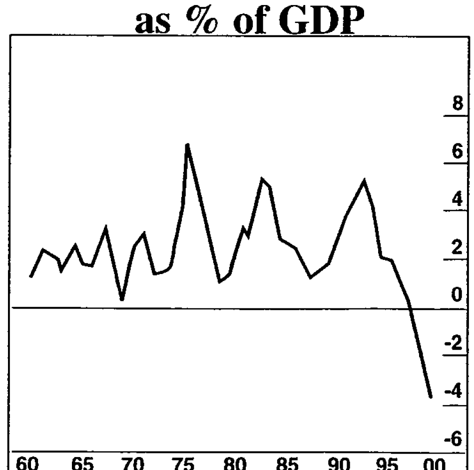
MEASURING THE BUBBLE EFFECT

The most spectacular effect of the artificially low interest rates and the resulting excesses in money and credit growth has been the protracted stock market boom. The critical and most dangerous features of a "bubble economy," however, are soaring debt levels and correlated distortions in the allocation of resources. Depending on different national "cultures" and priorities, these distortions in the economy's demand and output structures may greatly differ. In Japan's bubble period of the late 1980s, the bubble overwhelmingly fed into an investment spree on industrial plant and commercial real estate. Now in the United States, by contrast, the bubble is feeding overwhelmingly into a consumer borrowing and spending binge.

Take a good look at the following chart. It captures the best single measure of the impact of the asset bubble in the United Sates on the finances of the private sector. That is, on the difference between disposable income or private households and firms on the one hand, and their overall spending on consumption and investment on the other. Private households around the world do typically run a financial surplus in the aggregate, reflecting their savings. Just as typically, the business sector tends to run a financial deficit, owing to the fact that their investment spending normally exceeds their internal cash flow generated from capital depreciation and retained profits. In healthy economies, the two tend to match. In the United States, the private sector on average has run a financial surplus of around 2% of GDP with cyclical swings up to 4% of GDP during the whole postwar period.

As the chart shows, during the bubble years since 1995 this pattern has dramatically changed. Chiefly reflecting the consumer borrowing and spending binge and the correlated collapse in personal saving, the private sector's former financial surplus has turned into a substantial deficit. On the old national-account figures, the recorded excess old spending over current income was equal to 5.5% of GDP. Statistical revisions have trimmed it to 4% of GDP. Measured against the financial surplus posted during the first half of the 1990s, this indicates a bubble swing of about 7% of GDP.

Private Financial Balance as % of GDP



Source: Bureau of Economic Analysis

Yet this rampant excess of consumer and business spending over disposable income is only part of the financial horrors because it captures only the borrowing that has financed the spending on goods and services. As explained, the far larger part of the increase in debts that has been directed into the financial markets to buy bonds and stocks, is completely left out of account in this calculation of the private financial sector's deficit.

For comparison: In the case of Japan, the bubble-related swing in the financial balance of the private sector was from a prior surplus equal to 7.3% of GDP to a mini-surplus of 0.8% in 1990. Given the very high personal saving ratio of almost 10% of GDP, the private sector in Japan never went into financial deficit. Comparing these figures with those of the United States, as mentioned above, the U.S. bubble is clearly the worse of the two in terms of magnitude. The other important difference is in the substance of the bubble. In the case of Japan, the salient, macroeconomic imbalance was in overinvestment; in the U.S. case, it is in overconsumption, both of them fueled by an unsustainable debt mania.

The third and most critical difference between Japan's past and America's present bubble is in the exposure to foreign lenders and investors. Japan was and still is the world's biggest creditor country with a big current surplus. So when the bubble burst, the central bank could cut its interest rates in full freedom from the balance of payments. America, however, is the world's biggest debtor country with a monstrous current deficit that makes it dependent on continuous, huge capital inflows. Once the U.S. economy begins to weaken and Mr. Greenspan wants to help it with easier money and a lower interest rate, he and his admirers will painfully realize that U.S. monetary policy has become hostage to these capital inflows.

ON LANDINGS

Most American policymakers and economists seem to see but one single threat to America's booming economy: a rising inflation rate that forces the Fed to further and further rate hikes. They completely miss the the huge, unsustainable misdirection of resources imparted to the economy through the egregious credit excesses of the past years. Professor Wynne of the Jerome Levy Economics Institute of Bard College has counted and analyzed seven "unsustainable Processes."

Last but not least, it is completely ignored that in prolonging the dreadfully unbalanced and unsound U.S. economic boom, simply maintaining the rampant credit expansion is not enough. No, it inherently requires progressive money and creation. The comparison with the drug addict who depends on ever-larger injections is by no means far-fetched. Any substantial slowdown in credit growth is sure to undercut the boom.

Most American economists, apparently, are completely unfamiliar with the notion of an unsustainable imbalance. So let's briefly illustrate its essence by way of a striking example: the collapse in personal saving. Its crucial role in powering the U.S. boom is undisputed. Still, it ought to be obvious to anyone with common sense that such a dissaving process cannot continue indefinitely at a progressive rate. With personal saving in the United States now down to almost zero, it is time to explore the eventualities.

The London Economists recently reported about a study exploring this scenario. It considered three different possibilities: In the first, saving remains close to its present low of almost zero; in the second, saving gradually reverts over a five-year period to it long-term average; and in the third, it recovers abruptly and sharply in response, for example, to a stock market crash, overshooting its long-term average.

Wishful thinking hopes for the first scenario. In fact, in order to avoid a recession, private net saving has to remain at its current record low. Still, the absence of additional dissaving is enough to slow economic growth over coming years to an annual average of 1.8%. People tend to overlook that it requires permanently more and more dissaving just to maintain economic growth.

In the second scenario, presuming a gradual increase of saving over five years to its long-term average, the economy virtually stagnates during this period with average annual economic growth of 0.4%. The third scenario, unsurprisingly, delivers the hardest landing, implying effectively the famous case of the bursting of the bubble, embodying the crash of the stock market, crash of the economy and crash of the dollar.

Three possible scenarios—each one more ugly than the last. Mr. Greenpan's policies have been credited with saving the economy when, with his excessive monetary looseness, he has in reality merely postponed and

magnified the coming, inevitable crisis. Of these three eventualities, the first one seems to come closest to bringing a soft landing to the economy, and for good reasons, it is also the one which the markets are hoping for. Nevertheless, even this one is anything but benign. Most probably, nobody has ever bothered to think even this scenario through to its bitter end.

The key point to realize is that any rise in savings essentially exerts a drag on economic growth and thus squeezes profits. But consider above all the highly negative ramifications of zero domestic savings for economic growth and inflation in the longer run.

While slower economic growth may look benign in the short run, it is in reality only hard landing postponed. It will tend to forestall further rate hikes, but it is the cure that will undercut the euphoric perception of the U.S economy's superior economic health and strength, by which stock market boom and dollar strength are conditioned.

If you think it over, you realize that the three scenarios differ only in the speed with which the ultimate hard landing arrives. Scenario one and two give the bulls only a longer rope to hang themselves with. Given absurdly inflated economic and financial expectations, people will be shocked at how quickly the impressive strength of the economy could just vanish.

TRAPPED

What is really sustaining bullish sentiment about the U.S. stock market and, propping up the dollar? When asked, everybody pulls the same trump card: Faith in the economy's superior qualities, and faith in the unique wisdom of Mr. Greenspan. No further explanation is needed. His name stands for two tacit presumptions: *first*, that any signs of undesired economic weakness will prompt the Fed to instant rate cuts; and *second*, that the U.S. economy and the financial markets will just as promptly respond to any monetary easing.

Okay, let's assume that the U.S. economy shows more sluggishness than Mr. Greenspan and investors (domestic and foreign) like. The difference between desired and undesired economic weakening, by the way, may be no more than a hair's breadth. Smelling lower interest rates, the stock market may even be pleased, at first. However, there is another market of crucial importance to the well-being of the U.S. economy and its financial system where such prospects are liable to cause a shock, and that's the currency market. Slower economic growth and lower U.S. interest rates are unambiguously bad news for the dollar. And what's bad for the dollar is bad for the needed capital inflows, and what's bad for capital inflows is bad for the financial markets.

It is reported that measured bullish sentiment on the dollar is at an absolute peak, as against an extreme low in bullishness on the euro. Considering the present unattractiveness of the U.S. financial markets on the one hand, and the excessive and dangerous dependence of the dollar on uninterrupted, huge capital inflows to finance the yawning current-account deficit on the other, the U.S. currency's resilience is certainly most astonishing, if not enigmatic. Back to the question of what Mr. Greenspan will do when the U.S. economy's growth starts to disappoint. There is no doubt in the markets that he will instantly fight any threat of recession by immediately cutting rates and loosening his credit reins. In reality, he will face the catch-22 situation of his life. Prompt monetary easing may help the slowing economy and even launch a rally in the stock market, but he would take an incalculable risk on the grossly overvalued dollar. Some downward adjustment may be desirable. But with the monstrous current-account deficit looming in the background and only a minimal interest rate advantage against the euro, the U.S. currency is vulnerable to any slight shift in market perception and psychology as never before.

The experience of 1985-88 suggests that once the dollar begins to fall, a self-accelerating bandwagon easily develops. At the time, the dollar's earlier steep rise turned abruptly into an equally steep plunge that erased its prior gain by about 100% within less than three years. Apparently a major factor behind the dollar's sudden,

sharp reversal was a drastic shift in economic growth between America and Europe. While slowing in the United States in real terms from 6.8% in 1984 to 3.4% in 1985 and 2.7% in 1986, in Europe it accelerated from 1.4% to 2.8% and 3.9% during the same year.

Traditionally, American monetary policy has been strictly geared toward domestic requirements. Fending off a threatening recession has always had absolute priority, regardless of what happened to the dollar. Given the relatively small share of foreign merchandise trade in the economy, it seemed an appropriate principle. In short, the tail should never wag the dog. In this light, it seems a foregone conclusion that Mr. Greenspan, too, will act accordingly, once the economy weakens more than desired.

CHANGE IN THE RULES OF THE GAME

As already noted, a catch-22 dilemma is waiting for him. Quite possibly, the link between the falling dollar and domestic price level may still not bother him. But over the last few years, another linkage has grown to crucial, overriding importance, and that is the linkage between the dollar, capital inflows and the stability of the financial system. The problem is that the stability of both the dollar and the financial system over the last years has become singularly fated on the persistence of huge credit and capital inflows that have to finance not only the gargantuan current-account deficit, running now at an annual rate of more than $400 billion, but also very substantial capital outflows on the part of U.S. corporations and investors.

In fact, there is far more at stake than merely the financing of current outflows. An even bigger threat to the dollar looms in the existing, vast foreign holdings of dollar assets that have in particular accumulated in the last few years and are now soaring faster than ever. According to latest official calculations, these amounted to almost $2,700 billion on Dec. 31,1999, of which $1,837 billion was on private account and $833 billion on account of central banks.

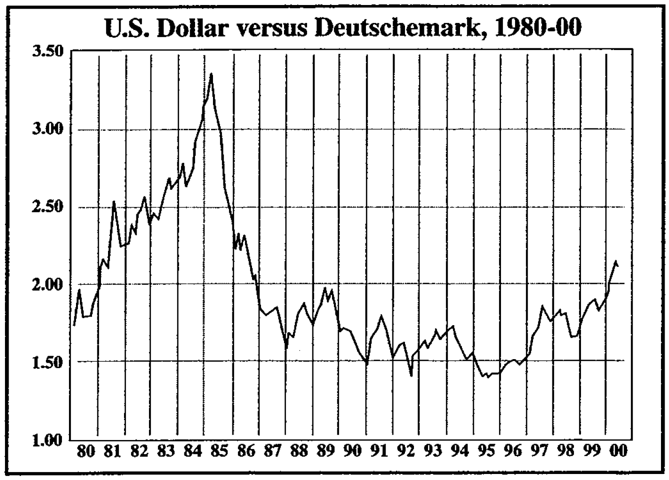
What few seem to realize is that this unprecedented dependence of the dollar and the U.S. financial system on uninterrupted, huge capital and credit inflows has thoroughly changed the rules of the game for U.S. monetary policy. It has created conditions under which the dollar tail could indeed—would most probably would—wag the big economic and financial U.S. dog. Once lasting dollar strength begins to be questioned in earnest and people's willingness to increase their exposure to the dollar dries up, the full force of both the current-account deficit and the horrendous, existing foreign dollar holdings will, finally, impact the currency and the financial markets.

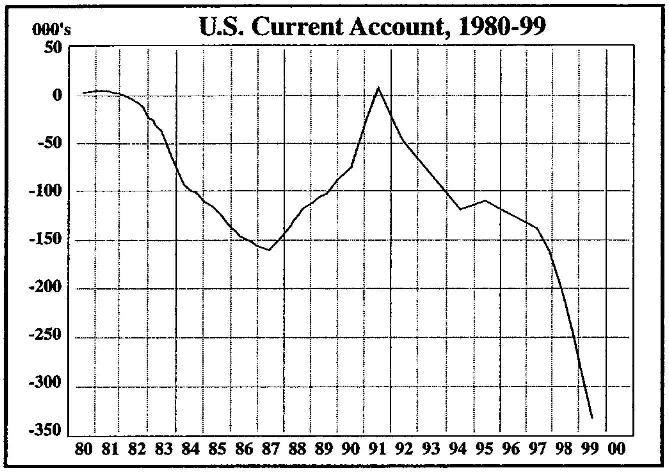
In order to get some idea of the looming risks, it is necessary to also visualize the market dynamics that are sure to come into operation once the dollar starts its definite decline. An important point to keep in mind is that any slowdown in investment and credit inflows relative to the current-account deficit and U.S. capital outflows instantly weakens the dollar. Yet, pondering potential, dangerous market dynamics, we see the incalculable, greatest hazards in the linkage between existing dollar trillions in foreign hands and the futures and derivatives markets.

Their owners may be slow in unwinding their positions by selling their dollar assets outright and converting the proceeds into euro or yen. Many of them, however, will be inclined to play at least temporarily for safety and lock in the dollar value by selling the U.S. currency forward through the futures and derivatives markets. As heavy, one-way selling of this kind develops, the institutions making these markets are, in turn, compelled to hedge their forward purchases of dollars in entirety by selling corresponding amounts in the spot market.

In this way, the forward sales will immediately translate into correspondingly large spot sales of dollars. It is this reflection in particular that frightens us of a possible, if not probable sudden bandwagon effect against the dollar, once the confidence in its stability begins to wear off. There is no precedent in history where the economy of the world's major currency vehicle has been so preposterously out of balance.

A sliding dollar will, in turn, promptly close the spigot of capital inflows—with dramatic effects on the U.S. financial markets, showing up in plunging stock and bond prices, that is, in rising market interest rates. The resulting crunch in the financial markets is the link through which the plunging dollar will rapidly spread recession. The hard landing has arrived.





What will and can Mr. Greenspan do under these circumstances? Slash interest rates? Before long, it will dawn on him and the markets that his freedom to pilot the economy away from the threatening recession through easier money is less than zero. As this alarming realization spreads, it is sure to precipitate the dollar's slide into a free fall. Hoping to prevent a bottomless dollar crash with inflationary implications, the Fed will probably feel compelled to raise its interest rate and tighten its monetary reins which, by he way, has always been normal policy for normal countries. The important point is that a responsible and prudent central banker will never allow such stupendous internal and external imbalances to develop.

LULL BEFORE THE STORM

Saying this, we have to admit that the dollar's resilience against the euro has rather surprised us, considering the battered U.S. financial markets, on the one hand, and the unfolding economic recovery in Europe, on the other. This is precisely the pattern of conditions that is prone to undercut the dollar. The usual inertia of an established trend is one explanation. Yet we are inclined to regard it as the lull before the storm. The favorite explanation for the greenback's strength against the euro has been that it reflected massive direct investment and portfolio inflows from sclerotic Europe in search of the superior returns offered by super-efficient Corporate America. But given the badly faltering U.S. stock market, it is hard to believe that it continues to be the great magnet for European corporate and personal capital.

As a matter of fact, we have always been wary of this explanation of dollar strength. The soaring capital inflows have been of very different kinds, and considering their immense total, it is naive to pick out one specific part as the determinant one. It is, of course, what the bulls want to believe. Looking at the big picture, it is obvious that credit flows have played a far greater role in driving up the dollar than flows into U.S. stocks. A large part of European acquisitions in the United States, by the way, take place through the exchange of stocks. The biggest single component in U.S. capital inflows were foreign purchases of U.S. corporate and U.S. government-agency bonds.

Put simply, what has been boosting the dollar was predominantly the sheer pressure of the U.S. borrowing binge that spilled over in particular into the vast, integrated credit market of the Euro area. As to the most recent development, anecdotal evidence suggests that the dollar's strength may primarily reflect bank inflows. Given perceptible strains in the U.S. credit markets, credit demand has shifted from the markets and toward the banks which, in turn, are drawing on the Eurodollar market. This channel, by the way, was the predominant source of dollar strength in the 1980s.

But for capital flows to impact the currencies, it is the indispensable condition that foreign lenders and investors generally abstain from hedging their positions by selling dollars forward in the futures and derivatives markets. This willingness to build up uncovered dollar holdings, clearly, presupposes the expectation of a stable, if not rising, dollar. That has been the case for more than five years. Woe betide the dollar, though, once this expectation weakens or reverses. In that event, as explained, foreign dollar holders will at some point race into hedging against a fall of the dollar—with the effect of precipitating it.

With flexible exchange rates, the behavior of currencies has become highly destabilizing in the short run because the great majority of investors and lenders, willingly or unwillingly, operate with a very short-term horizon, compared with the long lags before the weight of "fundamentals" gain the upper hand over short-term expectations. In fact, there is a wide-spread view in the markets that the dollar is bound to go down in the longer run, but that it could still go up before that happens. More important in our view is that the higher the dollar rises and the longer its inevitable decline is postponed, the greater the risk of later, heavy overshooting in the opposite direction.

AN OMINOUS PARALLEL

By the way, a strong linkage between a falling dollar and a crunch in the financial markets is by no means an entirely new phenomenon to the United States. It happened in a pronounced way for the first time in 1987. As expected improvements in the United States trade balance failed to materialize, in the course of the year both the dollar and the financial markets had become increasingly sensitive to the bad trade figures. Despite massive dollar purchases by central banks, these data and reviving inflation fears kept downward pressure on the dollar, and through it also on the bond and stock market.

Every time the dollar weakened, it sent bonds and stocks tumbling. During a particularly severe dollar attack between late March and mid-May, U.S. long-term interest rates spiked by from 7.5% to nearly 9%. In the wake of this turbulence, the Fed—by then under Greenspan—boosted its Federal funds rate within barely three months by 1.75 percentage points to 7.25. The dollar steadied, but failed to rebound. Meanwhile, the yield on long-term bonds had shot up to 10.4%. By October, the stock market staged its big crash.

But doesn't this experience of 1987 suggest just the opposite, that such disturbances are manageable? In our view, a more thorough comparison of prevailing conditions, then and today, reveals rather that the fundamentals underlying the U.S. economy and its financial system have dramatically worsened since then.

Such a comparison has to begin with noting one very importance difference: In 1987, the dollar already had a steep decline behind it. Nonetheless, it required massive interventions by the central banks to prevent it from collapsing into a black hole. Over the whole year, the central banks acquired a record $120 billion in dollar assets, effectively 84% of the $143 billion U.S. current-account deficit.

Paradoxically, the global stock market crash in October 1987 may have importantly helped to stabilize the dollar by leading, in its aftermath, to coordinated, global monetary easing. Something similar will surely happen when dollar and financial markets crash next time.

Yet we see one difference of fatal importance between the conditions then and today, and that is the outrageous magnitude of the economic and financial imbalances that have been allowed to pile up in the U.S. economy during the last years. This alone guarantees the worst dollar crash of all times.

Just about everything is astronomically worse today than it was in 1987. To mention only the most obvious imbalances: The current-account deficit, the level of foreign holdings of dollar assets, the debt levels of consumers and businesses, stock valuations and financial leverage across the whole financial system, near-zero personal savings. Altogether, this makes, in our view, an unmanageable mix of dangerous imbalances.

Reaping the whirlwind of a crashing dollar, in particular against the euro, is meanwhile the mutual

nightmare of policymakers both in America and Europe. For investors it is an unbeatable bargain in the making. Capturing the optimal timing is the only uncertainty. Implicitly, a sliding dollar will usher in the great crunch in the U.S. financial markets and the full-blown crash in the stock market. Weighing relative difficulties and opportunities of speculation in the various markets, there can be no question that the currency play is by far the most promising.

To profit from plunging share prices requires shorting individual stocks or stock indexes. But given the tremendous diversity of stock markets, this involves considerable risk even in times of a general bear market. Besides, shorting stock is tremendously expensive and for the individual investors and far too complicated.

The biggest and also easiest speculative killings have, in fact, always been made, with high leverage, in the bond and the currency markets. Mr. Soros made his single biggest profit—around $ 1 billion—in the currency markets through highly leveraged speculation against the British pound. Shrewd as he is, we are sure that he is aware of the big bargain that is presently waiting in the wings of the currency markets by going long in the euro against the dollar. He and other hedge funds could, with their firepower, well precipitate the dollar's inevitable crash. We keep wondering whether he and other hedge funds will seize this opportunity, even if they see it. Challenging the City and Whitehall in London is one thing, challenging Wall Street and Washington is something quite different.

THE BIGGEST POLICY CHALLENGE

In fact, there is another very important difference: Forcing the Pound Sterling into steep devaluation was a British calamity; forcing a steep decline of the dollar would spell disaster for America and the whole world. The Bank for International Settlements is the first among the international institutions to hint quite openly at this possibility:

> *Looking further ahead, the biggest policy challenge could be coping with a sudden reversal in the fortunes of the dollar. The additional deflationary impact on Japan would clearly be unwelcome, although much less so in Europe, where inflationary concerns have mounted. Even here, however, problems could arise if the rebound of the euro went too far and too fast. Given the extent to which the recent decline in the euro was unexpected, and that momentum-related factors could reverse, this possibility should not be dismissed.*

How deep can the dollar fall? Against the yen, it has plummeted by almost 45% from its highs in 1998 to its lows in 2000. As to its coming slide against the euro, we take it for granted that the dollar will test its lows of 1995 in relation to the European currencies. Considering that this was DM 1.35 against the German currency, this would suggest a plunge by about 30% from the present level. For the reasons explained, however, we regard today's dollar as far more vulnerable.

Of particular importance is, of course, the dramatic deterioration in U.S. foreign trade and indebtedness. In 1995, the U.S. deficit in current account had been $113 billion in the red. Presently, it is running in excess of $400 billion annually. During the four years since the dollar's low in 1995, U.S. *net* foreign indebtedness has roughly doubled by about $830 billion to more than $1,600 billion.

THE DOLLAR CYCLE

Definitely the most important difference between the situation in 1995 and today for the currency outlook looms in the developing shift between the American and European business cycle. In 1995, the U.S. economy entered a strong cyclical upswing, while the euro area entered a protracted phase of economic sluggishness. Presently, the opposite, that is, the dollar-bearish cyclical divergence is unfolding. Economic growth in Europe is distinctly accelerating; growth in the United Stated is either decelerating or will decelerate in the foreseeable future.

Ever since the end of World War II, the historical record shows that divergent economic growth between the United States and Europe has exerted the single, strongest influence on the dollar. Whenever U.S. economic growth overtook European growth, accelerating investment and credit inflows into the United States boosted the U.S. currency. Conversely, the dollar has just as regularly weakened whenever capital inflows decelerated in the wake of slowing economic growth. To be right on the dollar, you have to be right on the U.S. business cycle. What happened in the last few years to the business cycle and the dollar is the mirror image of what happened to the dollar between 1982-85. And the next few years will be the mirror image of what happened to the U.S. business cycle and the dollar after 1985.

THE HIGHEST INFLATION RATE

America's famous New Economy was supposed to deliver rapid growth with little inflation. Well, there is less inflation than expected. Yet America's inflation rate is high in the present global environment. It looks even less lustrous when one recalls that the recorded rate has heavily benefited from changes in the way the government statisticians measure inflation. By the late 1990s, these changes have lopped nearly a percentage off the consumer price index—kicking up in the process both real economic growth and productivity gains.

Now to present interest rate differentials between the dollar and euro. In the Euromarket, the 3-month dollar rate is at 6.5%, compared with a rate of 4.5% for the same maturity. Looking at the bond markets, 10-year German government bonds, the benchmark for the euro area, are presently yielding 5.22%, as against a 5.99% yield on U.S. Treasuries of equal maturity. In the long-term area, thus, the differential is less than 1%, and that in a country that has abolished saving. What's more, these differentials in nominal rates ought to be also seen against the backdrop of the fact that, year-over-year, U.S. consumer prices are up 3.1% against a rise by 1.9% in the euro area.

Drawing this comparison between interest rate and inflation rates and taking furthermore the huge and soaring U.S. trade deficit, the runaway credit expansion and multiple other manifest signs of an overheated U.S. economy into account, one begins to realize that Mr. Greenspan has done an excellent job in keeping U.S. interest rates artificially low.

ODD MONETARY PRUDENCE

Despite these overwhelming signs of unprecedented credit excesses and an overheating economy, Mr. Greenspan chooses to act as late and as slowly as possible, overriding a minority in the Fed that favored a more aggressive approach in reining in domestic demand. Ironically, domestic demand growth has actually accelerated since the Fed began applying its homeopathic medicine. It has taken him a full year to effect five rate cuts by 75 basis points. But these increases followed the quick cuts by 75 basis points in the autumn of 1998 in the wake of the Russian meltdown.

Seen in this light, interest rates are only 1 percentage point above their level two years ago. Given, however, a simultaneous rise in the rate of consumer price inflation from 1.7% in 1998 to lately 3.1 %, real interest rates have in reality fallen. But not only has Mr. Greenspan been unusually hesitant in raising the Fed's interest rate, over and above he has deliberately blunted their impact by preparing the markets each time for an impending move. Regular prompt rallies of the stock market in response to the Fed's rate hikes speak for themselves.

This extremely cautious policy stance also compares oddly with policy stances in previous, similar periods. Principally, central banks used to frontload their monetary tightening. Between February 1994 and February 1995, even Greenspan himself raised 300 basis points within a year, from 3% to 6%, and that did not occur in gradual steep-moves, but with several increases of 50 basis points and even one of 75 basis points. The previous tightening phase from March 1988 to February 1989 took short rates up 325 basis points in less than a year, from 6.5% to 9.5%.

One can only ponder why Mr. Greenspan has decided to proceed in his policy stance with such unusual caution this time if he truly believes in the economy's superior health and strength. There is but one reasonable explanation for the single-mindedness with which he set about flooding the economy with a deluge of money. He is aware of the fearful shakiness of the American financial system. No less puzzling is the fact that this extraordinary hesitation in applying the monetary brakes, even in the face of the most atrocious credit excesses in history has not even dented his credibility as the world's most astute central banker. We guess it is faith in his ability and determination to perpetuate the bubble, though at a more moderate pace of expansion. It is the only thing that today's crowd of stock investors care about.

A TIGHTENING FARCE

If you think all this over, you can't help to conclude that Mr. Greenspan's monetary stance is in reality a tightening farce. During the past nine months, broad money supply (M3) has expanded by an astounding $463 billion, or at a 10% annualized rate. He apparently hopes that the little he has done or may yet do will be sufficient to get some of the speculative froth out of the market and that diminished wealth effects will slow economic growth to a rate that qualifies as soft landing.

Long ago we learned that central banks should be judged by the specific risk they tend to take. When in doubt, do they tend to err in their policy decisions toward the tight side or toward the soft side? The Bundesbank principally preferred to err toward the tight side. We don't think Mr. Greenspan is erring toward the soft side. It is his deliberate intention to keep monetary policy as loose as possible, not because he does not wish to tighten, but because he is afraid of the enormous imbalances in the economy and the financial system.

By opting to keep the Fed funds rate unchanged at 6.5%, but accompanied with a hawkish assessment of the risk of inflation, the Fed is sticking to the strategy that has won it so many plaudits during the past years: Seize any excuse to do nothing. The press release said: "Recent data suggest that the expansion of aggregate demand may be moderating toward a pace closer to the rate of growth of the economy's potential to produce. Although measured prices are rising slightly faster than a year ago, continuing rapid advances in productivity have been containing costs and holding down underlying price pressures." Wall Street was quick to celebrate. Is it never mentioned that the soaring trade deficit has been and still is the most effective lid on U.S. inflation.

PHANTOM GROWTH

Referring to higher productivity gains to justify extravagant monetary looseness certainly is something entirely new in the history of monetary policy. It is the central tenet of America's new paradigm economy and the bull market that it has spawned. Yet, Mr. Greenspan must be aware what the true chief source of these productivity gains is: statistical manipulations - sorry, revisions - by use of so-called hedonic price adjustments.

In its recently published third annual report on the economic effects of computers and the Internet, the Commerce Department calls the information-technology industry the No. 1 driver of the U.S. economy, having accounted for one-third of U.S. economic real growth over the past five years even though their share of economic output is only 8%. In the first quarter of 2000, IT hardware and software accounted for 39% of real GDP growth.

The report shows that the benefits of information technology "are quickly spreading across the board and eventually will touch every business from the smallest mom-and-pop shop to the biggest Fortune 100," Commerce Secretary William Daley said. Over the four-year period, labor productivity in the nonfarm business sector has, indeed, increased at an average of 2.8% annual rate, fully 1.30 percentage points faster than prevailed over the 1972-95 period.

First of all, it strikes us as absolutely ridiculous that the production of information technology should

represent such a huge share of economic activity. In fact, this share is a pure statistical phantom generated overwhelmingly by the use of the hedonic price indexes, according to which computer prices, for example, have fallen 26% a year for the past five years. It's really a marvelous statistical technique that delivers everything the markets like to see - higher real GDP growth, higher productivity growth - except one thing: falling product prices don't generate income growth. It's an entirely new phenomenon in economics: productivity growth without correlated income growth. This goes, of course, a long way to explain why most Americans neither see nor feel anything of this widely heralded productivity miracle. It's a statistical mirage.

With this remark, briefly back to the dollar. It is the widespread view in the markets that the growth gap between America and Europe is of permanent, structural nature, and not just a temporary, cyclical phenomenon. The general conclusion is that this makes permanent dollar strength a sure thing. Taking our usual careful look at the U.S. GDP numbers in "chain" dollars, we conclude instead that about two-thirds of the apparently superior U.S. economic growth performance over the last four to five years has been pure statistical fiction and one-third cyclical. This, by the way, is roughly the result of new econometric investigations by Professor Robert J. Gordon of Northwestern University, a noted authority on productivity.

Putting it rather more bluntly: The glowing New Economy story does not fit the facts. Oddly, all this is the exact mirror image of what happened in the 1980s. Then, the great American bull story was behind "supply-side tax cuts" and other measures (Reaganomics) that would lift the American economy instantly from stagflation to a new era of productivity and prosperity. There was even precisely the same scornful view of the deplorable state of Europe's economy, at the time epitomized as "Eurosclerosis." And then as today, European politicians and managers readily joined the lamentations about their inferiority in macro and microeonomic management. For the end of the story, please take a look at the chart on page 6. It tells you, how it will end this time, albeit rather worse.

CONCLUSIONS:

Judging by the persistent, rampant money and credit growth, monetary restraint continues to be non-existent in the U.S. economy. Yet, cracks are showing in widening spreads in the credit markets and in the stock market's unusually high volatility. You might call it "exhaustion of excess."

The warning is clear: If the Fed fails to slow the economy sufficiently, which will only delay the inevitable hard landing, the markets are sure to do it, instead. The wealth effects that have powered U.S. economic growth are gone, and there is no chance for their return.

Critical to the global development will be the crash of the dollar against the euro.

THE RICHEBÄCHER LETTER

Dr. Kurt Richebächer, Editor
Published by The Fleet Street Group
Laura Davis, Group Publisher

Doug Noland, Market Analyst
Aimee Grable, Marketing Manager
Brian Flaherty, Design & Layout

For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 1217 St. Paul Street, Baltimore, MD, 21202. Subscription orders may be placed toll free from inside the U.S. by calling (1-888)737-9358, or from outside the U.S. by calling (1-410) 234-0691. Fax (1-410) 223-2553. Subscription rates: in the U.S.: $497. Outside U.S.: $545. Published monthly.